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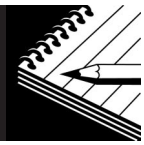

Welcome to the Jungle

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Editor's Note: *This is the first of a series of essays on chapter 11 practice for the newly minted chapter 11 professional. In this article, the authors give an overview of the jungle that can be chapter 11, offering a few words on what bankruptcy is about, and then a brief description of the game and the players. Almost everything stated here will also be covered at greater length in subsequent columns.*

The overwhelming majority of bankruptcy cases involve debtors who have no assets to distribute to creditors and who are filing just to get the discharge. There were about a million and a half such cases in the past year. These are important cases for the people involved, and they provide work for a lot of lawyers. But they aren't our department, and we won't spend a lot of time on them. Instead, we will spend most of our time on the cases where the debtor does have assets, and where the goal is to "reorganize" (whatever that may mean – of which more will be discussed later).

Bankruptcy law is federal. It is federal because the Constitution says that Congress shall have the power to make bankruptcy law. Congress exercised the power through the Bankruptcy Reform Act of 1978 (BRA), including the Bankruptcy Code, which is codified in Title 11 of the U.S. Code.

The BRA creates bankruptcy courts that operate as "a unit of" the U.S. district courts. Formally, the big distinction is in the power of the judge: The district judge exercises his judicial power under Article III of the Constitution and is a lifetime appointee, while the bankruptcy judge is a term appointee (14 years), deriving his or her power from the bankruptcy clause in Article I of the Constitution. Because the bankruptcy judges are "Article I" judges, case law holds that there must be limitations on the power of a bankruptcy judge in order for the bankruptcy system to be constitutional. As a result, Title 28 of the U.S. Code was amended to put the bankruptcy judge under the "supervision" of the district judge: Certain decisions by a bankruptcy judge must be reviewed by a district judge, and the district judge can withdraw matters that are pending before the bankruptcy judge and instead decide them herself. But practically speaking, the overwhelming majority of what happens in bankruptcy cases takes place in the bankruptcy court, under the supervision of the bankruptcy judge.

Who are the players in the bankruptcy game?

We have already mentioned the bankruptcy judge; he or she presides over the bankruptcy court. There are about 325 bankruptcy judges around the country, give or take. Some came to the bankruptcy bench with a lot of bankruptcy experience, some did not. But it may not make much difference: Lots of those without bankruptcy experience are fast learners, and some of them brought valuable experience from elsewhere—*e.g.*, good trial skills.

As with other judges, the relationship between bankruptcy lawyers and judges is a somewhat formal one. You typically deal with them either in court, on the record or through their staff. Regarding staffing, local practice may vary somewhat, but the chances are that the judge has a (a) secretary, (b) "courtroom deputy" who manages scheduling and the flow of paper and (c) law clerk. Tastes differ on how you communicate with the court: Some want you to work through the secretary, some through the deputy and some through the law clerk.

In addition to the bankruptcy judge's staff, you will also likely deal with the clerk of the bankruptcy court and the clerk's staff. The clerk's office is in charge of filing papers, assigning cases and, in some courts, scheduling matters. Because bankruptcy is so much of a paperwork process (and because of the high volume of cases), the clerk of the bankruptcy court plays an important role. A good clerk's office can make the bankruptcy process work much more smoothly for the judges and the lawyers alike. It is well worthwhile to develop a good working relationship with the bankruptcy clerk's office.

In the mass of ordinary bankruptcies (the "chapter 7 cases" discussed below), the case is administered by a trustee. The trustees are selected in rotating order from a "panel" of local trustees—typically lawyers, but sometimes accountants or other financial professionals. The trustee collects and liquidates the debtor's nonexempt assets (although, as noted above, in most cases there aren't any). He is generally empowered to "police" the case. Sometimes, the trustee hires lawyers to represent him.

Chapter 11 is different. There is no trustee unless the judge orders the appointment of one. In lieu of a trustee, the debtor remains in control of its business and assets as debtor-in-possession (DIP). The DIP has most of the powers and responsibilities of a trustee. In the typical case, it is the debtor who initiates the bankruptcy case through its (pre-bankruptcy) lawyer. Once it has filed, the debtor—now DIP—seeks court approval to retain its former lawyer as counsel for the DIP. The DIP's counsel becomes a kind of "point person" in the chapter 11 case.

Another important player in the bankruptcy system is the Office of the U.S. Trustee, a division of the Department of Justice that is charged with oversight of the bankruptcy system. The U.S. Trustee appoints and supervises panel trustees, appoints official committees (see below), reviews and comments on applications to

employ and compensate professionals, investigates bankruptcy fraud and abuse, and can be heard on any other issue in a bankruptcy case. The U.S. Trustee is often active in the very early stages of a chapter 11 case, although once the case is up and running, and particularly if there is active creditor participation, the U.S. Trustee often backs off a bit.

Another player well worth noting in a chapter 11 case (they are permitted in chapter 7 too, but it rarely happens) is the creditors' committee. The committee typically consists of the five or seven largest unsecured creditors that are willing to serve. It hires counsel (and sometimes financial advisors or other professionals) who are paid for by the debtor's estate. The committee has standing to be heard on any issue in a chapter 11 case, and its views tend to be taken seriously by the bankruptcy judges. An active and well-represented committee can play a major role in the outcome of the case. In some cases, other committees will also be appointed, such as equity-holder committees, retiree committees, bondholder committees, etc. Other important players include secured parties, especially banks that may have liens on substantially all of a debtor's assets, and counter-parties to executory contracts.

Now, a word about the structure of the Code. As we said above, the Bankruptcy Code is in Title 11 of the U.S. Code and is divided into chapters. Chapters 1, 3 and 5 are "general" chapters designed to govern all cases.

Chapter 11 contains definitions, delineates who can be a debtor, describes the courts' powers and contains some other general rules. Chapter 3 governs "administration of the case," including matters such as the filing of new cases, employment of professionals, the automatic stay, the use, sale and lease of estate assets, post-petition financing, executory contracts, the dismissal and closing of cases, and some other matters. Chapter 5 covers a wide variety of matters relating to the rights of debtors and creditors, including claims and priorities, matters relating to exemptions and discharge of debts, and the "avoidance" provisions, which permit a trustee or DIP to claw back certain transfers made prior to the petition date.

In chapter 7, the trustee liquidates the assets. Both individuals and business entities can be chapter 7 debtors. Corporate chapter 7 debtors are just liquidated and do not get a discharge (they don't really need one; liquidated corporations are not usually attractive defendants). Individual chapter 7 debtors turn over their nonexempt assets (if any) to the trustee, and then ordinarily get a discharge, which covers most (but not all) kinds of debts.

Chapter 11, entitled "reorganization," is the chapter that governs the small number of "big" cases that entail a lot of lawyer time and effort, and generate a lot of professional fees. If you ask a chapter 11 lawyer what it means to reorganize, he will likely say something like this: The reorganization case allows the debtor to preserve the business as a going concern, and thereby to maximize value for creditors, shareholders, employees and other stakeholders.

This is a beguiling picture and not entirely false. But there are all kinds of difficulties. The most obvious is that not all businesses are worth more as a going concern than they are in liquidation. A notorious example is the case of the Penn Central Railroad, one of the largest bankruptcies in American history. Penn Central went into bankruptcy as an unprofitable network of railroads, then emerged as a valuable real estate company.

A second difficulty is that chapter 11 specifically provides that a reorganization plan may provide for the liquidation of some or all of the debtor's assets—so chapter 11 is not only about reorganization, and the Code implicitly recognizes that in some cases value is maximized through liquidation. Third, the debtor does not need to choose chapter 11 if he wants the business to continue; the trustee may, with court approval, continue to operate the business in chapter 7 (although it is not often done). Finally, the distinction between "liquidation" and "going concern" may be less clear in practice than it is in theory. One can perfectly well "liquidate" a business by selling it as a going concern, in which case the distinction does not mean anything at all. Indeed, "going concern" sales—and the use of asset sales to circumvent the chapter 11 plan process—seem to be a popular trend these days.

Why this muddle? The point is that bankruptcy law conflates two concepts that are overlapping but fundamentally quite different. One is the notion of maximizing the value of the assets. The other is the notion of saving the residual stake of the pre-bankruptcy owners. This confusion is apparent in the classic chapter 11 case. The old residual owners (equity-holders), still in control of the enterprise, will file the petition. They will remain in control (as DIP) and will propose "a plan" to "save the going concern." If all goes well, the effect will be to maximize the payout to creditors and to leave something on the table for the owners (while preserving jobs, generating future tax revenues and serving other social goods that are often touted as benefits of reorganization).

Such a scenario appears to be a self-evident win-win situation. The interests of creditors and equity appear to be allied. But it is rarely that simple. "Saving the going concern" means continuing the business, which means continuing to bear risk. Where the business is insolvent, equity always gains from taking risks: Liquidate today, and they get nothing; keep the business going, and they may have a chance. Creditors are correspondingly risk-averse: Liquidate today, and they get paid. Take a gamble, and the rewards go to equity, while the creditors bear the risk of loss. The point is not that creditors always favor liquidation—clearly, they don't—but the risk-reward calculation is different for creditors than it is for equity-holders.

There can be no doubt that chapter 11 obscures, rather than resolves, this tension—almost as if deliberately to allow the court to choose, from case to case and even from time to time within a case, whether "assets" or "equity" will dominate.

Aside from chapters 7 and 11, there are a couple of other chapters for particular kinds of cases. Chapter 13 is for individual debtors who want to retain assets that they would have to give up in a chapter 7 case or to obtain a broader discharge than is available in chapter 7. In exchange, the chapter 13 debtor must use his income, after essential expenses, to pay off a portion of his debts over a three- to five-year period. Chapter 9 is for municipalities (the cases are few in number, but sometimes notorious). Chapter 12 is for "family farmers" (but plenty of farmers use chapters 11 or 7).

Aside from the Code, there are other places to look for bankruptcy law. The jurisdiction provisions are in Title 28 of the Judicial Code. There are some bankruptcy crimes in Title 18 of the Criminal Code. There is some bankruptcy tax law in Title 26 of the Internal Revenue Code.

But there is still more law. In a great many cases, the bankruptcy court is adjudicating rights that involve "other law"—*e.g.*, the non-bankruptcy law of property. So, the bankruptcy lawyer may have to be an expert, or at least versed, at this other law. (In fact, debtor's counsel can be analogized to a general contractor: He or she must know at least a little bit about many related but different areas.) In any particular case, this can mean anything. Most often, it means non-bankruptcy debtor-creditor law, notably Article 9 of the Uniform Commercial Code (secured transactions in personal property) and non-bankruptcy mortgage law.

Aside from the statutes, bankruptcy has "rules." There is a set of Federal Rules of Bankruptcy Procedure, a cousin to the

Federal Rules of Civil Procedure. And bankruptcy courts also have their own local rules, which should be (but are not always) consistent with the more general bankruptcy rules. Most bankruptcy courts have web sites, and the local rules are generally available on the web sites.

Next Issue: The lifecycle of a chapter 11 debtor through the debtor's eyes. ■

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